No. 354

In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ELLIOTT H. WHEELER, ET AL., EXECUTORS OF THE ESTATE OF JAMES H. WHEELER, DECEASED, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM IN OPPOSITION TO PETITION FOR REHEARING

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1. The Court's opinion in this case holds, *inter alia* (p. 3), that Article 115–3 of Treasury Regulations 101, promulgated under the Revenue Act of 1938, "is reasonable and a valid exercise of the rule-making power" and that under that regulation the Wheeler Company was required to compute its earnings and profits resulting from the sale of securities which it had acquired in tax-free exchanges, upon the basis of the transferors' cost of those securities. The opinion pointed out that the regulation represented the administrative interpretation of the law in which the Commis-

sioner had persisted despite adverse decisions on the point by the Board of Tax Appeals and certain lower courts, and noted that before the question was finally judicially considered Congress had clarified the point "by enacting the substance of the regulation" in Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974.

Part one of the respondents' petition for rehearing is predicated upon the suggestions (a) that the regulation has a different meaning from that attributed to it by the Court, and (b) that the Commissioner had taken positions inconsistent with the regulation prior to the enactment of Section 501. We point out that these issues were developed *in extenso* in the respondents' original brief herein (pp. 16, 25, 28–30, 30–34, 62–65), and the Court will recall that a substantial portion of the oral argument was devoted to them. In any event, respondents' position upon these points is untenable.

(a) Article 115–3 provides that—

> Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.[1]

[1] It will be observed that the regulation applies to "gains and losses within the purview of section 112 or corresponding provisions of prior Acts." Cf. petition for rehearing, pp. 29–30.

When the Wheeler Company sold the securities involved in this case, "the extent" to which a gain resulted under Section 112 was the difference between the price which it received for those securities and the cost of them to the company's transferors. That was "the time" and "the extent" that the gain to the corporation was recognized; and under the regulation it is to that extent that the gain was required to be reflected in the corporation's "earnings and profits."

It is not true that the Tax Court has ever announced, much less "persisted in" or "established" (cf. petition for rehearing, pp. 5–9), a construction of the regulation contrary to that made by this Court. The fact is that the Tax Court has never construed the regulation; nor has it ever expressly decided whether the regulation represented a permissible interpretation of the statute by the Treasury, to which has been committed the rule-making power under the revenue laws. As our brief pointed out (pp. 22–25), although the promulgation of the regulation antedated the first decisions by the Board of Tax Appeals upon the problem, those cases involved tax years prior to those governed by the regulation, and the Board therefore did not consider either its meaning or its validity. In those cases the Board construed the statute in a manner different from that provided by the regulation; thereafter, in subsequent cases the Board adhered

to its views, not, however, upon the basis that the regulation was not intended by the Commissioner to apply to cases of the instant type, but upon the authority of its own prior decisions.

The petition for rehearing repeats the respondents' contention that the regulation applies only to one facet of a tax-free exchange. It is said that the regulation applies where a corporation transfers, in a tax-free exchange for the stock of another corporation, assets which have appreciated in value; that in such a case the effect of the regulation is to provide that the unrecognized gain resulting to the transferor corporation should not at that point affect its earnings and profits available for dividend distribution; *F. J. Young Corp. v. Commissioner*, 35 B. T. A. 950, affirmed, 103 F. 2d 137 (C. C. A. 3d), is referred to as illustrative of the problem with which the regulation is concerned. It is further suggested that the question as to the proper basis to be used by the transferee corporation for the purpose of determining its earnings and profits upon subsequent disposition of such assets, is an entirely unrelated question and is one, furthermore, which is not dealt with either by the regulation or by Section 501.

The regulation does, of course, deal with cases of the *Young* type. Respondents' further suggestion, however, that cases of the instant type present a wholly different problem and that the

regulation deals only with the *Young* type of question, is not correct. The contention is refuted not only by the plain language of the regulation, but by the Tax Court's treatment of these issues, by the treatment accorded them by Congress when it came to enact Section 501, and by the administrative treatment thereafter.

The Tax Court has treated cases of the *Young* type and cases of the instant type as involving but facets of a single problem. It has never suggested that any different considerations were involved in the one aspect of the problem from those involved in the other. Quite to the contrary, it has cited the *Young* case as supporting its decisions in cases of the *Wheeler* type. Thus, in *Elmhirst* v. *Commissioner*, 41 B. T. A. 348, 354 (a case of the instant type), it said:

> Since *W. S. Farish & Co.* has been affirmed, 104 Fed. (2d) 833, by the Circuit Court of Appeals for the Fifth Circuit, and since the same conclusion, in effect, in *E. J. Young Corporation*, 35 B. T. A. 869, has been affirmed by the Circuit Court of Appeals for the Third Circuit, 103 Fed. (2d) 137, further discussion of this point is unnecessary, and we hold, in accordance with said cases, that the proper basis is the basis of cost to the corporation.

See also *Falkland Corp.* v. *Commissioner*, decided November 8, 1941 (1941 P-H B. T. A. Memorandum Decisions, par. 41,497).

And Congress treated the questions together when it enacted Section 501. The first sentence of the Section dealt with the *Wheeler* aspect of the problem, and the second sentence dealt with the *Young* aspect.

Finally, in the regulations promulgated under Section 501 (T. D. 5024, 1940–2 Cum. Bull. 110), both aspects of the question are dealt with in a single example (example 1, p. 113) illustrating the application of the Section.

(b) The charge that the Commissioner at times took a position inconsistent with the regulation is based upon cases which all involved tax years prior to those first covered by the regulation. Thus, *W. & K. Holding Corp.* v. *Commissioner*, 38 B. T. A. 830, is cited as a case of the instant type, and *Freshman* v. *Commissioner*, 33 B. T. A. 394; *McCormick* v. *Commissioner*, 33 B. T. A. 1046, and *Lea* v. *Commissioner*, 35 B. T. A. 243,* are cited as cases of the *Young* type in which the Commissioner's position was contrary to that of the regulation. However, the regulation was first promulgated under the Revenue Act of 1934, and the *McCormick* case involved the year 1925, the *Freshman* and *Lea* cases the year 1929, and the *W. & K. Holding Corp.* case the year 1933. No case has been cited, and we know of none, involving a year subsequent to the time when the Treasury's view became crystallized and embodied in

* Reversed, 96 F. 2d 155 (C. C. A. 2d).

the regulation, in which there has been any inconsistency.

Moreover, we do not agree that the cases cited by the respondents show any inconsistency even prior to the time of the promulgation of the regulation, but it seems unnecessary to undertake here an analysis of them to show that they are not in point. We note, however, respondents' statement (petition for rehearing, p. 7) that in the *W. & K. Holding Corp.* case "The Commissioner argued exactly the opposite of what he is arguing here." In view of that statement, we have examined the briefs which were filed in that case. Although in that case the Board suggested *obiter* (38 B. T. A. at pp. 840–841), that upon the disposition by a corporation of an asset acquired in a tax-free exchange, the corporation would not use the same basis for the determination of its earnings and profits as would be applicable for the determination of taxable gain or loss, the suggestion appears to have been wholly gratuitous on the part of the Board, for none of the briefs contained any discussion of that question and none of them cited any of the cases to which the Board referred in its dictum.

2. There is no issue here with respect to the continuing authority of *Dobson* v. *Commissioner*, 320 U. S. 489. If there had been no regulation

[3] While in *Elmhirst* v. *Commissioner*, 41 B. T. A. 348, the regulation was not cited, the Commissioner's position was in accord with it.

upon the point, or perhaps even if there had been an open question concerning the meaning of the regulation and the Tax Court had construed it contrary to the Commissioner's position, the Tax Court's early view, as to the proper basis for computing corporate earnings and profits in a case such as the instant one, might have been thought to be entitled to finality under the *Dobson* case. That, however, is not the situation. The Tax Court had not construed the regulation, but had simply refused to follow it, adopting a position tantamount to a holding that it was invalid, and as the *Dobson* case expressly noted (320 U. S. at p. 502) a question of the validity of a regulation is clearly one of law.[4]

3. With respect to the final point made in the petition for rehearing (pp. 30–31), it seems sufficient to observe that the regulations[5] have long provided that tax-exempt income is included in a corporation's earnings and profits, and (Paul,

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[4] The point was so treated by the Sixth Circuit in *Commissioner* v. *Fisher*, decided March 26, 1945 (1945 C. C. H., par. 9239). It held the regulation invalid and upon that premise applied the *Dobson* case to reach the conclusion that the view announced by the Tax Court in its early decisions was entitled to finality. A petition for rehearing has been filed and is pending in the *Fisher* case.

[5] See Article 1541 of Treasury Regulations 45, 62 and 65; Article 621 of Treasury Regulations 74 and 77; Article 115–1 of Treasury Regulations 86; Article 115–3 of Treasury Regulations 94 and 101; Section 19.115–3 of Treasury Regulations 103; and Section 29.115–3 of Treasury Regulations 111.

Selected Studies in Federal Taxation (Second Series) 149, 162).

> It is well settled that dividends, to the extent not embraced in corporate net income, are to be added thereto in computing "earnings or profits."

CONCLUSION

The questions raised by the petition for rehearing were fully presented to the Court and are without merit. The petition should therefore be denied.

Respectfully submitted.

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